No. 5955.

IN THE

United States

Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

Joseph O. Koepfli, Roland P. Bishop and William T. Bishop,
Petitioners and Appellants,

vs.

Commissioner of Internal Revenue,
Respondent.

BRIEF FOR APPELLANTS.

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BRIEF FOR APPELLANTS.

(All Italics Ours.)

INTRODUCTION.

This is an appeal by the petitioners, Joseph O. Koepfli, Roland P. Bishop and William T. Bishop, from a judgment entered in the United States Board of Tax Appeals, in favor of the respondent, the Commissioner of Internal Revenue.

STATEMENT OF THE CASE.

The three petitioners were for many years prior to 1922, and all during that year, partners in the firm of Bishop and Company. Each owned a one-third interest.

In 1905 they purchased a tract of 6.24 acres of land lying along 8th street, between Alameda and Lawrence streets, in the city of Los Angeles, California. The purchase price was $94,610.74. In 1907 they put up a concrete building on the property at a cost of $94,134.19. In 1908 and 1909 other improvements were erected amounting to $5,543.73 and $21.92, respectively. The land and buildings were sold by the petitioners in 1922 for $500,000.00, the net to petitioners being $476,179.90.

The petitioners contended that the March 1, 1913 value of the property sold by them in 1922 was $466,132.27 and that the net taxable gain was only $10,047.63. The respondent determined the March 1, 1913 value to be $345,463.54, resulting in a net taxable gain of $152,901.39, or $50,967.13 to each partner.

The petitioners appealed the Commissioner's determination to the United States Board of Tax Appeals. The cases, being consolidated for trial, were heard by the board in Los Angeles, California, on April 11th and 12th, 1928. Under date of October 4th, 1928, the said board rendered its findings of fact in accordance with the facts hereinabove alleged, further finding, however, that the fair market value of the land as of March 1, 1913, was $382,797.80 and that the value of the buildings was the value as determined by the respondent, viz., the depreciated cost of the buildings as of March 1, 1913. The said board on the said date also rendered its opinion in which it concluded that, "The amount of taxable gain resulting from the sale of this property should be recomputed based upon a value of $382,797.80 for the land, plus the depreciated value of the buildings, all as of March 1, 1913."

On December 17, 1928, the said Board entered its final order of redetermination wherein it determined deficiencies against the petitioners, Joseph O. Koepfli, Roland P. Bishop and William T. Bishop, for the year 1922 in the amounts of $3,890.38, $2,665.53 and $2,696.94, respectively. From this order appeal is taken to this Honorable Court.

QUESTION INVOLVED.

The question involved in this appeal is solely a question of law which may be succinctly stated as follows:

In determining the gain in 1922 on the sale of property acquired prior to March 1, 1913, when the basis is cost or March 1, 1913, value, whichever is the higher, is it required under section 202(b) of the Revenue Act of 1921 that the cost basis be reduced by depreciation accrued or sustained prior to March 1, 1913?

ASSIGNMENT OF ERRORS.

In raising the above question, there was set forth the following assignments of error as grounds for this appeal:

1. The Board of Tax Appeals erred in its conclusion of law that "the amount of taxable gain resulting from the sale of this property should be recomputed, based upon a value of $382,797.80 for the land plus the depreciated value of the buildings all as of March 1, 1913", in that the law does not require that cost of improvements erected prior to March 1, 1913, must be reduced by depreciation accrued to March 1, 1913, and the Board's conclusion should have been that the amount of taxable gain resulting from the sale of this property should be recomputed

based upon a value of $382,797.80 for the land plus the cost of the buildings, all as of March 1, 1913.

2. The Board of Tax Appeals, in its order of redetermination of the tax liability, erred in its computation of such tax liability for the reason that in computing profit on the sale of the 8th and Alameda street property, said Board reduced the basic cost of improvements on said property by depreciation accruing prior to March 1, 1913, and such reduction of cost by depreciation accruing prior to March 1, 1913, is contrary to law.

3. If the Board determined that the fair market value of the improvements (buildings) as of March 1, 1913, was represented by their depreciated cost on that date, then the Board erred in failing to compute the profit on the sale on the basis of cost of improvements rather than the March 1, 1913, value since the cost is greater than the March 1, 1913, value, and Sec. 202(b) of the Revenue Act of 1921 in effect requires that the basis for ascertaining the profit on the sale of property acquired prior to March 1, 1913, is the cost of such property or its fair market value as of March 1, 1913, whichever is higher.

STATUTES.

This case, concerning income taxes for the year 1922, is directly controlled by the provisions of the Revenue Act of 1921, but since later acts will be referred to in the argument, pertinent provisions thereof are quoted in this section of this brief for reference purposes.

Revenue Act of 1921.

> "Section 202(a). That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed,

acquired after February 28, 1913, shall be the cost of such property; * * *

"(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value."

Revenue Act of 1924:

"Section 202(a). Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

"(b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account and (2) *any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, previously allowed with respect to such property.*

"Section 204(b) The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property * * * or (B) the fair market value of such property as of March 1, 1913, whichever is greater."

Revenue Act of 1926.

Section 202(a)—Same as section 202(a) of the Revenue Act of 1924:

"(b) In computing the amount of gain or loss under subdivision (a) * * * (2) The basis shall

be diminished by the amount of the deductions for exhaustion, wear and tear, obsolescence, amortization and depletion which have since the acquisition of the property been allowable in respect of such property under this act or prior income tax laws; * * * *In addition, if the property was acquired before March 1, 1913, the basis (if other than the fair market value as of March 1, 1913) shall be diminished in the amount of exhaustion, wear and tear, obsolescence, and depletion actually sustained before such date.*"

Section 204(b)—Same as section 204(b) of the Revenue Act of 1924.

Comments on History of Sections of the Revenue Acts Relating to Basis for Determining Gain or Loss on Sale of Property.

(a) In General.

The Revenue Act of 1913 and all subsequent acts have provided for an annual deduction from gross income for depreciation, but not until the Revenue Act of 1924 was there any expressed statutory requirement that depreciation be considered in the computation of the gain or loss resulting from the sale or other disposition of depreciable property. Prior to the passage of the 1924 Act, the authority for such consideration was found only in the Commissioner's regulations and the decisions of the Bureau of Internal Revenue. The Revenue Act of 1921 contained no provision with reference to the use of depreciation in the computation of gain or loss. The Revenue Act of 1924 added the provision that the basis should be diminished in the amount of exhaustion, wear and tear, obsolescence and depletion "previously allowed with respect to such property". The Revenue Act of 1926 revised the 1924 addition by providing that the basis should be dimin-

ished in the amount of exhaustion, wear and tear, obsolescence and depletion "which have since the acquisition of the property *been allowable* under this act or prior income tax laws", and it further added another and new provision that "if the property was acquired before March 1, 1913, the basis * * * shall be diminished in the amount of exhaustion * * * sustained before such date".

The Revenue Act of 1924 was the first to make mention of adjustments to be made for depreciation and then only with regard to depreciation after 1913 since depreciation after 1913 was the only depreciation within the category of depreciation "previously allowed". It will undoubtedly be admitted that under this provision, if the taxpayer took no depreciation and if none was allowed, in the income tax returns filed by that taxpayer from 1913 to date of sale, the basis for determining gain on the sale would not be reduced by depreciation accruing from 1913 to the date of sale. Supposing the basis was cost in such a case—would it be at all consistent to say that the basis would have to be reduced by depreciation accruing prior to 1913, but not by depreciation accruing subsequent to 1913? There was no depreciation "allowed" prior to 1913 since there was no income tax law in existence at that time. There is therefore no provision in either the 1921 or 1924 Revenue Acts specifically requiring the basis to be diminished by depreciation sustained or accrued prior to March 1, 1913.

(b) Revenue Act of 1926.

The Revenue Act of 1926 went beyond the requirements of the 1924 Act. It required that the basis be reduced by depreciation which since the date of acquisition of the

property has been "allowable" under the various Revenue Acts. Then, recognizing that this would not cover the situation prior to 1913 when no income tax acts were in effect, the 1926 Act contained an additional and new provision to the effect that if the property was acquired prior to March 1, 1913, the cost basis would have to be reduced by the depreciation actually sustained before March 1, 1913. The fact that this new provision was inspired by the recognition that the provisions of the previous acts were not sufficient may readily be appreciated from the reference in the report of the Ways and Means Committee to the House of Representatives to this new provision, which stated as follows:

> "When property is acquired prior to March 1, 1913, the present law provides that in the case of a sale of such property the basis for determining gain or loss shall be cost or March 1, 1913, value, whichever is higher; and also provides that in making adjustments for depreciation, etc., proper adjustment shall be made for depreciation, etc., 'previously allowed'. Owing to the fact that there was no income tax prior to March 1, 1913, in cases where property was acquired prior to that date no depreciation has been 'allowed', and the taxpayer may receive too large a basis for determining gain or loss. The amendment proposed provides that the deductions for depreciation, etc., to be made in such cases shall be such deductions as were actually sustained with respect to such property, which would include such depreciation as had occurred prior to that date."

The report of the Senate Finance Committee to the Senate contained the same statement as above quoted.

(c) Revenue Act of 1924.

Since the Revenue Act of 1924 was the first to mention the use of depreciation as affecting the basis, it is interest-

ing to note, particularly in comparison with the Committee Reports above quoted with reference to the 1926 Revenue Act the Committee Reports concerning the gain or loss from sale provisions of the 1924 Act. This language is found in House Report 179, the report of the Committee on Ways and Means to the House, February 11, 1924:

> "Section 202. There is no provision of the existing law which corresponds to this section of the bill. The purpose in embodying in the law this section is to show clearly the method of determining the amount of gain or loss from the sale or other disposition of property * * *.
>
> "(2) There is no provision in the existing law which corresponds to subdivision (b), but the rule laid down therein is substantially the same as the construction placed upon the existing law by the Treasury Department. It provides that in computing gain or loss from the sale or other disposition of property the cost or other basis of the property (and in the appropriate case the fair market value as of March 1, 1913) shall be increased by the amount of items properly chargeable to capital account and decreased by the depreciation and similar deductions allowed with respect to the property. Under this provision * * * *items such as depreciation and obsolescence previously allowed* with respect to the property *are to be subtracted from the cost* of the property in determining the gain or loss from its subsequent sale."

The Senate Finance Committee Report contains practically the same language.

There is no ambiguity in the above quotation which is an expression of the intention of Congress as to the meaning of the particular section of the law being explained. It states clearly that the provision as to the consideration of depreciation as a reduction of the basis is a new provision; that items such as depreciation and obsolescence

previously allowed with respect to the property (and in the 1926 Act, *previously allowable* with respect to the property) are to be *subtracted from the cost* of the property in determining the gain or loss from its subsequent sale. It does not provide that the cost shall be reduced by depreciation sustained from date of acquisition; nor does it provide that the basis shall be cost depreciated to March 1, 1913; it merely provides that the basis, whether *cost* or March 1, 1913, value, shall be reduced by the depreciation previously allowed under prior Revenue Acts. It is very significant that in the Committee Reports on the 1926 Revenue Act it is recognized that "owing to the fact that there was no income tax prior to March 1, 1913, in cases where property was acquired prior to that date no depreciation has been 'allowed' * * * the *amendment* proposed provides that the deductions for depreciation to be made in such cases shall be such deductions as were actually sustained with respect to such property, which would include such depreciation as had occurred prior to that date". The "amendment" referred to is the brand new provision of section 202(b)(2) of the Revenue Act of 1926 which has hereinbefore been quoted. (*Supra*, pp. 7-8.)

(d) Revenue Act of 1921.

In setting out the foregoing comments concerning the Revenue Acts of 1924 and 1926, it has not been overlooked that the instant case is controlled by the Revenue Act of 1921. In fact, the consideration given to the subsequent acts is pertinent and essential to the determination of the proper interpretation of the 1921 Revenue Act, particularly as to the question involved.

Section 202 (a) of the Revenue Act of 1918 contained the brief provision that in the case of sale of property the basis for determining gain or loss shall be:

> "(1) In the case of property acquired before March 1, 1913, the fair market price of value of such property as of that date; and
>
> "(2) In the case of property acquired on or after that date, the cost thereof; * * * "

The report of the Ways and Means Committee to the House (H. R. 350, Aug. 16, 1921), relating to the provisions of section 202 of the Revenue Act of 1921 stated:

> "In the case of property acquired before March 1, 1913, under existing law, the basis for determining gain or loss is the fair market price of such property as of that date. The decision of the Supreme Court in the case of Merchants Loan & Trust Co. v. Smietanka (decided March 38, 1921) makes necessary not a fundamental modification of that rule but a more detailed statement of its application.
>
> "The proposed bill gives explicit effect to the doctrine approved in that decision; provides that the general basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property shall be the cost of such property; but that in the case of property acquired before March 1, 1913, (1) if its fair market price or value as of March 1, 1913, is in excess of the cost, the gain to be included in the gross income shall be the excess of the amount realized therefor over the fair market price as of March 1, 1913; (2) if its fair market value as of March 1, 1913, is lower than cost, the deductible loss shall be the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and (3) if the amount realized therefor is more than cost but less than its fair market price or value as of March 1, 1913, or less than cost but more than such fair market price or value, no gain or loss shall be recognized."

In the Finance Committee Report [S. Rep. 275, Sept. 26, 1921] to the Senate regarding the same section, the following appears:

> "Section 202 provides in detailed form for the basis (used in case of sale * * * of property) for determining gain or loss. Because of the decisions of the Supreme Court in the case of Goodrich v. Edwards and Walsh v. Brewster (decided March 28, 1921) it is necessary to state explicitly in the statute, the method of treating gain or loss accrued prior to March 1, 1913. Heretofore property held on March 1, 1913, has been considered capital as of its value on that date. The concession of the Solicitor General in the above cases, adopted by the court, is to the effect that gain or loss in every case is determined upon the basis of cost or acquisition value and not by the March 1, 1913 value of the property, the gain or loss accruing before March 1, 1913, however, being excluded for purposes of computing the net income subject to tax."

Then follows the same explanation of the revised section as appears in the Ways & Means Committee Report.

The Supreme Court cases mentioned in the above reports and which will forthwith be examined, contain absolutely no statement by which it could be inferred that the court was construing the section in any manner as requiring the basis to be reduced by depreciation accrued prior to March 1, 1913.

Merchants' Loan & Trust Co. v. Smietanka (255 U. S. 509) held that the term "income" comprehended appreciation in the value of a capital asset, and that when such appreciation was realized it could be taxed as "Income" under the Sixteenth Amendment to the Constitution. This case was considered under the Revenue Act of 1916, which however was held in *U. S. v. Flannery,* 268 U. S. 98, to be

of the same effect insofar as the sections concerning basis for determining gain or loss are concerned, as the Revenue Act of 1918.

Goodrich v. Edwards, 255 U. S. 527;
Walsh v. Brewster, 255 U. S. 536;
Lucas v. Alexander, 279 U. S. 573;
Involving sales of stock under the Revenue Act of 1916.

The Supreme Court has held that where the transaction shows an *actual gain* and the March 1, 1913, value is less than the cost, the *taxable gain* is ascertained by subtracting the cost from the selling price (holding as to second transaction in *Walsh v. Brewster, supra*); and that where there is an *actual gain*, and the March 1, 1913 value is greater than the cost, the *taxable gain* is ascertained by subtracting the March 1, 1913 value from the selling price (holding as to first transaction in *Goodrich v. Edwards, supra*; and in the single transaction involved in *Lucas v. Alexander, supra*).

U. S. v. Flannery, 268 U. S. 98;
McCaughn v. Ludington, 268 U. S. 106;
Involving sales of stock under 1918 Revenue Act.
Heiner v. Tindle, 276 U. S. 582.
Involving sale of house under 1918 Revenue Act.

In *U. S. v. Flannery, supra*, the taxpayer undertook to deduct as a loss the difference between the sale price and the March 1, 1913 value. This was disallowed, for the reason that the sales price showed a gain over the cost, and the court held that, as there was no actual loss, there was no deductible one. But in cases where the transaction involved disclosed an actual loss and that the March 1, 1913

value was greater than the cost, it has been held that the deductible loss is ascertained by subtracting the sale price from the cost. This was the conclusion as to the transaction involved in *McCaughn v. Ludington, supra,* where there was an actual loss, and the March 1, 1913 value was greater than the cost. And the same proposition was affirmed in the case of *Heiner v. Tindle, supra.*

In *Heiner v. Tindle, supra,* the property involved was a dwelling house. It was purchased in 1892 at a cost of $172,000.00. In 1901 the taxpayer ceased to use it as a residence, and on October 1, 1901, devoted it exclusively to the production of taxable income in the form of rentals, a transaction for profit. He continued to lease it until 1920, when it was sold for $73,000.00. The fair market value of the property on March 1, 1913, was $120,000.00. Its value on October 1, 1901, when it was exclusively devoted to the production of income, was not found. In his tax return for 1920, the taxpayer deducted as a loss $47,000.00, the difference between the March 1, 1913, value ($120,000.00) and the sales price ($73,000.00). The Commissioner disallowed the deduction and assessed an additional tax upon the $47,000.00. The tax was paid and suit was brought. The District Court sustained the collector in disallowing the deduction. The Circuit Court of Appeals reversed the District Court. The Supreme Court reversed the judgment of the Circuit Court of Appeals and remanded the case for a new trial so that the value of the property on October 1, 1901, when rented, may be found, with the instruction that "if that value is larger than the value as of March 1, 1913, the deduction made below should be allowed; *if less, only the difference, if any, between its then value and the sales price should be allowed.*"

The last case is probably of more direct interest than the others since it alone concerns the basis to be used in the case of the sale of depreciable property. Still, no analysis of this case can disclose any requirement that cost be reduced by depreciation accrued prior to March 1, 1913. On the contrary, remembering that in that case cost was the 1901 value, the court specifically stated that "if that value is larger than the value as of March 1, 1913, the deduction made below should be allowed; if less, only the difference, if any, between its then value and the sales price should be allowed." *Nothing said about depreciating such value to March 1, 1913.*

And in the other cases cited above, nowhere is there mention of reducing cost by depreciation accrued or sustained prior to March 1, 1913.

These cases are mentioned because, as explained by the Legislature, the Revenue Act was amended to comply with the decisions of those cases, and since those decisions made no rule requiring the reduction for depreciation, the amendment which did not specifically make such requirement cannot be construed to impliedly contain such a requirement. As an example of the general language used in all these cases the following quotation is taken from the case of *U. S. v. Flannery, supra:*

> "These decisions" (referring to *Walsh v. Brewster* and *Goodrich v. Edwards*) "are equally applicable to the Act of 1918, * * * As it was held in these decisions that the Act of 1916 imposed a tax to the extent only that gains were derived from the sale, and that the provision as to the market value of the property on March 1, 1913, was applicable only where a gain had been realized *over the original capital investment,* so we think it should be held that the Act of 1918 imposed a tax and allowed a deduction to the

extent only that an actual gain was derived or an actual loss sustained *from the investment*, and that the provision in reference to the market value on March 1, 1913, was applicable only where there was such an actual gain or loss; that is, that this provision was merely a limitation upon the amount of the actual gain or loss which would otherwise have been taxable or deductible."

ARGUMENT.

Section 202 (b) of the Revenue Act of 1921 Must be Interpreted in the Ordinary Meaning of Its Terms. The Term "Cost" Does Not Mean "Cost Less Depreciation Sustained Prior to March 1, 1913."

The sole question involved is whether in determining the cost basis in computing the gain on the sale of depreciable property, the cost should be reduced by depreciation accruing from date of acquisition to March 1, 1913.

As will be noted from schedules appearing on pages 52-53 of the Transcript of Record, the amount of the accrued depreciation prior to March 1, 1913 and deducted from cost, was $11,297.93 ($10,207.80 on the main building and $1,090.13 on the engine room). Petitioners contend that actual cost, without reduction for this depreciation, should have been used as the basis for determining gain, thus reducing by $11,297.93 the taxable profit computed by the Board as having been realized upon the sale of the property during the year 1922.

As has been stated, section 202 of the Revenue Act of 1921 provides that the basis in determining gain on the sale of property acquired prior to March 1, 1913 is the *cost* of such property or the fair market value of such property as of March 1, 1913, whichever is higher. For purposes of this case the question of March 1, 1913 value can be

eliminated since the taxpayer failed to prove a March 1, 1913 value and since such value is allowed solely for the purpose of limiting the *actual gain* to that portion of it which accrued subsequent to March 1, 1913. (*U. S. v. Flannery, supra.*)

The question, further reduced, resolves itself into this—is the term "cost" as used in the Revenue Act to be construed as "original capital investment" or "cost," or is it to be construed as "original cost less depreciation" sustained prior to March 1, 1913? The very statement of the question seems to answer it. The courts cannot add something to the law which does not appear there. Certainly then, should the court construe the term "cost" as "cost less depreciation," is it not adding something to the law? Is it not adding words, "less depreciation," which are not included in the ordinary definition of the term "cost," and which add a provision and meaning to the law which does not appear in the law? Is it not in effect an act of legislating by the court? (*U. S. v. Watt*, 1 Bond 580.) It has been shown that Congress had occasion to review very carefully these sections of the Revenue Act and it must be concluded that Congress by reason of its careful consideration of these sections, chose its terms with great care and purpose and intended the terms to be applied according to their ordinary meaning. It is not within the power of the court, therefore, to modify or enlarge the meanings of those terms to justify a violation of those terms. (*Smietanka v. First Trust & Savings Bank,* 257 U. S. 602; *Treat v. White*, 181 U. S. 264; *U. S. v. Field,* 255 U. S. 257; *Gould v. Gould*, 245 U. S. 151.) The terms of the 1926 Revenue Act may not be applied to cover the omission in the earlier acts. (*Smietanka v. First Trust*

& Savings Bank, supra.) As stated in the committee reports hereinbefore quoted, the provision in the 1926 Act, section 202(b) regarding the consideration of depreciation accrued prior to March 1, 1913, was an *amendment* of the previous acts and not a construction of those acts.

It is admitted that departmental regulations required the reduction of the basis by depreciation sustained prior to March 1, 1913, but it has frequently been held that the courts will give no effect to departmental regulations where such regulations are in conflict with express statutory provision (*U. S. v. Grimaud,* 220 U. S. 506; *U. S. v. Birdsal,* 233 U. S. 223; *U. S. v. Smull,* 236 U. S. 405; *U. S. v. Morehead,* 243 U. S. 607), or where the statute is not ambiguous (*Swift & Co. v. U. S.,* 105 U. S. 691; *U. S. v. Tanner,* 147 U. S. 661; *U. S. v. Alger,* 152 U. S. 384). The Commissioner of Internal Revenue cannot by his rulings and regulations increase the measure of the tax imposed by the statute (*Clicquot Club Co. v. U. S.,* 13 Fed. (2d) 655). The policy of the courts in this regard is defined in the case of *Gould v. Gould, supra,* as

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government and in favor of the citizen."

See also:

U. S. v. Coulby, 251 Fed. 982;

U. S. v. Wigglesworth, 2 Story 369;

American Net & Twine Co. v. Worthington, 141 U. S. 468;

Benziger v. U. S., 192 U. S. 38;

Schwab v. Doyle, 258 U. S. 529.

As stated by the Supreme Court in the case of *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364:

> "And the plain, obvious, and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover."

U. S. v. Ludey, 272 U. S. 295, distinguished

(a) THE DECISION THAT "COST" IS CONSTRUED AS MEANING "COST LESS DEPRECIATION ALLOWABLE AFTER MARCH 1, 1913" CANNOT JUSTIFY A CONCLUSION THAT COST MAY BE CONSTRUED AS COST LESS DEPRECIATION SUSTAINED BEFORE MARCH 1, 1913.

It is true that in the case of *U. S. v. Ludey*, 274 U. S. 295, which will hereinafter be discussed, the Supreme Court introduced a meaning to section 202 of the Revenue Act of 1918 which does not appear in the exact wording of the statute, but, as will hereinafter be pointed out, such interpretation was justified under the well established rule that statutes should receive a sensible construction to avoid an unjust or absurd conclusion (*In re Chapman*, 166 U. S. 661).

The Ludey case did not, however, hold that the cost basis for determining gain or loss should be reduced by depreciation *sustained prior to March 1, 1913.* It merely held that the basis, whether cost or March 1, 1913 value, should be reduced by depreciation sustained *subsequent to March 1, 1913, and allowable* under the Revenue Acts. The reasoning upon which this holding is based justifies it as a sensible and reasonable construction of the statute, but the same reasoning can not apply as grounds for holding that depreciation prior to March 1, 1913, should be deducted from the cost basis, since the facts can not support

such reasoning, and when the reasoning falls the conclusion based upon such reasoning must likewise fall.

The Ludey case involved a situation where the taxpayer held on March 1, 1913 certain assets which were acquired prior to that date, the value of which on March 1, 1913, was in excess of the original cost. The assets were sold in 1917 at a price which exceeded the March 1, 1913, value less depreciation and depletion from March 1, 1913, to date of sale. The taxpayer contended that the March 1, 1913, basis should not be reduced by depreciation and depletion sustained from that date to the date of sale, in determining the gain derived from the sale. With respect to this contention the court held:

> "Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years."

As to the meaning of "cost" as used in the opinion, the following footnote appears in the opinion:

> "Some of the properties were purchased before March 1, 1913. As to these the term cost is used, throughout the opinion, as meaning their value as of March 1, 1913, that value being higher than the original costs."

This footnote was not a restriction of the rule announced by the case but merely an explanation of the application of the term "cost" to the statement of facts in the case. If the facts had disclosed the original cost to be greater than the March 1, 1913 value, this particular footnote would have been unnecessary. It should also be noted that all other footnotes to the opinion in the case refer to the regulations and statutes concerning the depreciation allowable under the various Revenue Acts.

(b) The Ludey Decision Was Reasonable in That It so Construed the Term "Cost" as to Effect a Fair Result From a Tax Viewpoint.

Let us note the language used in the Ludey case:

"*The depreciation charge permitted as a deduction from the gross income* in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. *The amount of the allowance for depreciation* is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sum set aside will (with the salvage value) suffice to provide an amount equal to the original cost. *The theory underlying this allowance for depreciation* is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. *Any other construction would permit a double deduction for the loss of the same capital assets.*"

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"*The depletion charge permitted as a deduction* from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets."

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"*The corporation tax law of 1909 had failed to provide for any deduction on account of the depletion of mineral reserves.* (Stratton's Independence v. Howbert, 231 U. S. 399; von Baumbach v. Sargent Land Co., 242 U. S. 503; United States v. Biwabik Mining Co., 247 U. S. 116; Goldfield Consolidated Mines Co.

v. Scott, 247 U. S. 126.) *The resulting hardship to operators of mines induced Congress to make provision in the revenue law of 1913 and all later Acts for some deduction on account of depletion* in determining the amount of the taxable income from mines. It is not lightly to be assumed that Congress intended the fact to be ignored in determining whether there was a loss or a gain on a sale of the mining properties."

* * * * * * * * *

"The Court of Claims erred in holding that no deduction should be made from the original cost on account of depreciation and depletion; but it does not follow that the amount deducted by the Commissioner was the correct one. The aggregate for depreciation and depletion claimed by Ludey in the income tax returns for the years 1913, 1914, 1915, and 1916, and allowed, was only $5,156. He insists that more can not be deducted from the original cost in making the return for 1917. The contention is unsound. The amount of the gain on the sale is not dependent on the amount claimed in earlier years. If in any year he has failed to claim, or has been denied, the amount to which he was entitled, rectification of the error must be sought through a review of the action of the Bureau for that year. He can not choose the year in which he will take a reduction. *On the other hand, we can not accept the Government's contention that the full amount of depreciation and depletion sustained, whether allowable by law as a deduction from gross income in past years or not, must be deducted from cost in ascertaining gain or loss. Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer was entitled to deduct in the several years.*"

It is obvious from these quotations that the court was considering exclusively the reduction of the basis by depreciation allowable under the Revenue Acts. After stating that the "theory underlying this *allowance* for depreciation is that by using up the plant a gradual sale is made

of it," the court finds that such depreciation deductions should reduce the basis since "any other construction *would permit a double deduction* for the loss of the same capital asset." As previously stated the law favors a reasonable and sensible construction of a statute and this court's interpretation is therefore justified since any other construction would have permitted a double deduction, admittedly an unreasonable and unfair result. But such would not be the case with respect to depreciation sustained prior to March 1, 1913. As previously stated there is nothing in the decision in the Ludey case from which there might be drawn an inference that the court was laying down a rule that depreciation sustained before March 1, 1913, must be used as a reduction of the cost basis. That question was not before it. The court in a footnote refers to the decision of the U. S. Board of Tax Appeals in the case of *Even Realty Co.*, 1 B. T. A. 355, but it gave no expression of approval of the decision in that case. The Even Realty Co. case decided that both depreciation sustained after March 1, 1913, and depreciation sustained prior to March 1, 1913, should be used to reduce the cost basis. It is noteworthy, however, that in a later case decided after the Ludey case, in which the Board of Tax Appeals followed the ruling in the Even Realty Co. case, *seven members of the board expressed their dissent in that part of the decision requiring the cost basis to be decreased by depreciation sustained prior to March 1, 1913.* (*Noaker Ice Cream Co. v. Commissioner,* 9 B. T. A. 1100.)

A Reasonable Construction of Section 202 (b) of the Revenue Act of 1921 Would Not Require the Reduction of the Cost Basis by Depreciation Sustained Prior to March 1, 1913.

The question involved must be considered from a tax viewpoint rather than an accounting viewpoint. There is at issue in this case the interpretation of a taxing statute, which if construed strictly and literally supports the petitioners' contention. The statute states that the basis for determining the gain from the sale of property acquired before March 1, 1913, is the "cost" of such property (eliminating the provision concerning March 1. 1913, value since, under the facts, it is not a factor in this case). The term "cost" has but one literal and strict meaning. That meaning is the meaning the courts should give to it unless such an unreasonable result should follow that the modification of that meaning would be justified. As previously explained, the court for that reason, in the Ludey case, modified the meaning to allow consideration of depreciation sustained after March 1, 1913. But no unreasonable result occurs from that modified meaning if it is interpreted as ruling that no reduction is to be made for depreciation sustained before March 1, 1913. From a tax viewpoint, there exists no reason for further modifying or enlarging the terms of the statute, and since the result secured from the application of the term "cost," even as modified by the Ludey case, in its strict sense so as to prevent reduction of cost basis by depreciation sustained before March 1, 1913, is reasonable, fair and sensible, the court is enjoined to give it the interpretation which the ordinary meaning of the terms impart.

It was from a tax viewpoint that the Supreme Court decided the Ludey case, for its decision was based primarily on no other reason than that any other construction of the Revenue Act would permit the taxpayer a double deduction (*supra*, p. 23.) The court further stated, "On the other hand, we *cannot accept* the Government's contention *that the full amount of depreciation* and depletion *sustained, whether allowable by law as a deduction* from gross income in past years or not, *must be deducted from cost* in ascertaining gain or loss." Except that from a tax viewpoint the government's contention was not fair, why could not the court accept that contention? The court continues, "Congress doubtless intended that the deduction to be made from the original cost should be the aggregate amount which the taxpayer *was entitled to deduct* in the several years."

For taxation purposes deductions from gross income for depreciation and depletion are allowable only to the extent for which Congress has made provision by specific enactment. In the Corporation Tax Law of 1909 no provision was made for the deduction for depletion, hence none was allowable. (*Stratton's Independence v. Howbert*, 231 U. S. 399; *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503; *United States v. Biwabik Mining Co.*, 247 U. S. 116; *Goldfield Consolidated Mines Co. v. Scott*, 247 U. S. 126.) In subsequent Revenue Acts provision was made for deductions for depletion in certain limited amounts. Under the Ludey case the cost basis could not be reduced by depletion sustained in 1909, 1910, 1911 and 1912 since none was allowable under the Excise Tax Act of 1909, and could be reduced by depletion for subsequent years not in amounts actually sustained but only in such limited amounts as

were allowable as deductions from gross income under the respective Revenue Acts. Is it not therefore an absurd and unfair conclusion to hold that the basis must be reduced by the full amount of depletion sustained from the date of acquisition to 1909, particularly when the specific provision of the Revenue Act does not by its terms require such an adjustment?

Conclusion.

The petitioners respectfully urge that Section 202(b) of the Revenue Act of 1921 specifically prescribes that where cost is greater than March 1, 1913 value of property acquired prior to and sold after that date, the basis for determining *gain* from the sale is the *cost* of such property; that to construe the term cost in any but its ordinary meaning or to particularly construe it as meaning cost less depreciation sustained prior to March 1, 1913, is unjust and unreasonable, leading to absurd and unfair results, and therefore not a construction which the courts are permitted to give to a clear and unambiguous provision of a statute; and therefore the Board of Tax Appeals erred in reducing the cost basis by depreciation sustained prior to March 1, 1913. Petitioners pray that the Honorable Court sustain their contention and eliminate from the taxable profit realized in 1922 on the sale of property as determined by the board, the amount of $11,297.93 which is the amount of the depreciation sustained prior to March 1, 1913 and subtracted from the cost by the Board in determining the gain from the sale.

Respectfully submitted,

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